1-1-1980

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Recommended Citation

Auditing Symposium V: Proceedings of the 1980 Touche Ross/University of Kansas Symposium on Auditing Problems, pp. 127-141;

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Unique Audit Problems of Small Businesses that Operate under Managerial Dominance

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Many practitioners with small business clients believe that pronouncements of the Auditing Standards Board (ASB) are not responsive to their needs. Typically, the criticisms pertain to implementation problems stemming from existing statements on auditing standards. Commentators usually are not advocating that the profession should have two sets of generally accepted auditing standards (GAAS)—one set for public companies and another set for nonpublic companies. Rather, they ask questions like, how do you apply the guidance in SAS No. 12, Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments, if your client does not retain an attorney?

The purpose of this paper is to:

- Identify the characteristics of small businesses that generate unique audit problems.
- Briefly describe how the ASB is responding to the problem.
- Review existing AICPA and international guidance that addresses unique audit problems of small businesses.
- Review guidance contained in other published literature.
- Identify some of the implementation problems and possible solutions.

Characteristics of Small Business

The term "small business" as used in this paper is best described as an entity with some or all of the following characteristics:

1. Concentration of ownership or operational control in the hands of one or a few individuals.
2. Management personnel that have limited accounting experience and capability combined with an attitude that is not conducive to hiring employees having accounting expertise.
3. Internal accounting control weaknesses resulting from:
   - limited segregation of functions within the accounting system because of the small number of employees.

*The author wishes to express appreciation to Ellen C. Downey, Manager, and Martin J. Rosenblatt, Practice Fellow, Auditing Standards Division, AICPA, for their contributions to this paper. The views expressed by the author are personal and do not represent the views of the AICPA or any of its committees.

- easy access of clerical and administrative personnel to physical assets.
- informally designed procedures (planning, budgeting, accounting, reporting) dependent upon managerial style.
- high potential for management override.

4. No independent policy-making board.

These characteristics encompass both public and private businesses. Of particular interest is the characteristic of weaknesses in internal accounting control. Even in a small business having some of the above characteristics there may be selected areas where an auditor can place reliance on internal control. For example, controls over disbursement and receipt of cash and physical inventory counts may be of sufficient quality to enable audit reliance to be placed thereon. Also, as discussed later, there are practitioners who believe that if management of the small business exercises proper ''executive'' control, other areas of internal control may be relied upon to limit substantive testing.

Problem Background

The Cohen Commission publicly stated that the Auditing Standards Executive Committee (predecessor to the ASB) pronouncements were not responsive to small business clientele. The Commission said:[1]

> . . . variations in the size and nature of an entity will dictate variations in specific audit practices and procedures, *as contrasted to auditing standards* [emphasis added]. Present guidance on the application of auditing standards to audits of different size entities is inadequate. More attention should be accorded to the possible effect of variations in audit clients on the nature and extent of audit procedures; additional guidance specifically applicable to audits of smaller entities should be given.

The commission considered the proposition that there are significant differences between audits of public and nonpublic entities and concluded that criticism of authoritative auditing pronouncements for a failure to differentiate standards based on whether the client is public or nonpublic is misdirected. According to the commission, the problem relates to small entities, whether public or private.

In response to the Cohen Commission, the Review of Existing Auditing Standards Task Force was formed by the ASB in 1978. The task force was charged:

> To review existing auditing standards (a) to determine whether they are responsive to the needs of auditors of smaller companies, whether changes are needed because of changed conditions, and whether there are inconsistencies in existing literature; and (b) to develop necessary guidance as a result of such review or to recommend how and by whom such guidance should be developed.

In May 1978, the AICPA's Council adopted the recommendations of the Oliphant Committee on the structure of Aud SEC.[2] The committee stated that the ASB should provide ''. . . auditors with all possible guidance in the implementation of its pronouncements, by means of interpretation of its statements, by issuance of guidelines, and by any other means available to it.''[3] The Oliphant Committee also recommended that auditing standards and procedures should

". . . make special provisions, where appropriate, to meet the needs of small enterprise."[4] Consistent with this directive, the ASB, starting with the exposure of SAS No. 26, Association with Financial Statements, in May 1979, began to specifically request comment on the special needs of small business via the transmittal letter accompanying exposure drafts.

The Review of Existing Auditing Standards Task Force devoted its initial efforts to identifying inconsistencies in existing literature, which resulted in numerous editorial revisions, and to drafting a proposed SAS on "Adequacy of Disclosure in Financial Statements."[5] Then, at its first meeting in 1980, the task force agreed, based on its study of the literature, that existing auditing standards are relevant for businesses of all sizes. However, the task force also agreed that there is a need for more explicit guidance for auditors on the appropriate *implementation* of standards in the audit of small businesses. The form of guidance (SAS, audit guide, etc.) has yet to be decided by the task force.

AICPA Guidance

Four publications of the AICPA present limited guidance on the unique application of auditing standards in the small business audit. Two of these are statements on auditing standards and thus are authoritative; two are nonauthoritative technical practice aids (not governed by rule 202 of the Institute's Code of Ethics).

SAS No. 1, Section 320.35, which presents a conceptually logical approach to internal accounting control evaluation, contains the following:

> Reasonable assurance that the objectives of accounting control are achieved depends on the competence and integrity of personnel, the independence of their assigned functions and their understanding of the prescribed procedures. Although these factors are important, their contribution is to provide an environment conducive to accounting control rather than to provide assurance that it necessarily will be achieved. Accounting control procedures may be performed by personnel in any appropriate organizational position. In smaller organizations, such procedures may be performed by the owner-manager. In these circumstances, however, some of the limitations discussed in paragraph 34 may be particularly applicable.

The reference back to paragraph 34, discussing inherent limitations, cautions the auditor that procedures designed to assure the execution and recording of transactions in accordance with management's authorization may be ineffective against either errors or irregularities perpetrated by management.

Paragraphs 34 and 35 considered together leave the auditor in a quandry. Paragraph 35 appears to implicitly permit reliance on owner/manager internal controls in a small business. However, paragraph 34 warns auditors about management override of controls.

SAS No. 20, Required Communication of Material Weaknesses in Internal Accounting Control, issued in August 1977, specifically addresses material weaknesses in internal accounting control for which management believes corrective action is not practicable. In these situations, the auditor, according to paragraph 9 of SAS No. 20, may summarize the weaknesses and describe the circumstances (e.g., inadequate control over cash transactions because of inadequate segregation of duties due to limited personnel). The summary of material weaknesses may be presented in writing or communicated orally and is to be communicated to senior management and the board of directors.

Interestingly, three members of the board assented with qualification and three members dissented (out of 20 total members) to SAS No. 20. Each dissenter included in his objections a statement expressing concern about the application of SAS No. 20 to smaller or closely held businesses.

Turning next to nonauthoritative AICPA guidance, section 8200 of *Technical Practice Aids* includes an inquiry on the study and evaluation of internal control.

> *Inquiry*—Several small audit clients have weak internal controls. If the auditor elects to not rely on the client's internal control, may he omit his study and evaluation of the internal control system? . . .
> *Reply*—An auditor may not omit his study and evaluation of the client's internal control. The auditor may not have to conduct tests of compliance if he is not relying on the internal control, but the auditor must still study and evaluate the client's system of internal control as required by the second standard of field work. . . .

Implicit in the above commentary is the need for a practitioner to include in his audit work papers a conclusion with respect to the study and evaluation of internal control *even if he does not rely on internal control.* Such a conclusion might state:[6]

> On 12/2/X1, I updated our memoranda concerning the company's accounting and internal control systems, there was no significant change in these systems during the eleven months ended 11/30/X1.
> It is my opinion that the company's controls over the various accounting systems are such that:
> 1. They cannot be relied upon due to a lack of segregation of duties,
> 2. Various controls are not susceptible to testing, or
> 3. It would not be cost/effective for us to test the controls.
>
> Therefore, it is my opinion that our work should consist entirely of substantive procedures.

The above illustrative conclusion that the auditor would not restrict his audit procedures without performing compliance testing conforms with authoritative literature and also satisfies the requirement of SAS No. 1, Section 338.05 (''Working Papers'').

Another nonauthoritative AICPA publication is the recently published *Audit and Accounting Manual.*[7] The manual is intended to be responsive to local practitioner needs; therefore, one might assume that audit problems of small businesses would be extensively addressed. However, only two sections of the manual address unique small business audit problems. An illustrative internal control questionnaire (AAM 4300) and a flowchart illustration (AAM 4500) depict a small business.

The *Audit and Accounting Manual* questionnaire presents a list of questions an auditor might raise concerning a small manufacturing operation owned by one person who also serves as the general manager and has only a *few* employees involved in the accounting function. The questionnaire stresses the need for owner/manager (''executive'') controls. For example:

- Does the owner use operating budgets and cash projections?
- Are journal entries understood and authorized by the owner?
- Is the owner satisfied that all employees are competent and honest?
- Are write-offs and other adjustments to customers' accounts authorized by the owner?
- Does the owner verify that the trial balance of accounts payable agrees with the general ledger control account?
- Are vendors' statements checked by the owner periodically for overdue items?
- Are all checks signed by the owner?

The section on flowcharting in the *Audit and Accounting Manual* illustrates the purchases, receipt of stock, and cash disbursements for purchases, of the Kilroy Wholesale Grocery. John Kilroy, according to the scenario, owns and operates the business with two employees. One employee serves as both the stock clerk and truck driver. The other employee is the bookkeeper.

Absent guidance provided by the *Audit and Accounting Manual,* and especially considering the questionable usefulness of internal control flowcharts in the small business environment, one has to conclude that *authoritative* auditing literature and *nonauthoritative* practice aids promulgated by the AICPA do not extensively address unique problems encountered in the small business audit.

International Guidance

The Canadian Institute of Chartered Accountants (CICA), the Institute of Chartered Accountants in England and Wales (English Institute), and the Auditing Practices Committee of the Consultative Committee of Accountancy Bodies (APC)[8] have published documents pertaining to small business audits. As discussed below, the CICA study refers to a negative assurance audit report which has not become an acceptable reporting practice. The English Institute pronouncements also deal with audit reporting. The APC discussion paper sets out arguments for and against audit requirements for certain small companies.

Canadian Institute

In 1967 the CICA published an audit technique study entitled *Internal Control in the Small Business.* The study dealt with the audit problem of reporting on a small business having limited internal control. The study group suggested the use of a negative assurance report in situations where the auditors have done an audit and have found nothing materially misstated, but the internal control is dominated by the owner/manager of the small business. The suggestions made in the study have *not* been accepted.

According to the study group, the first paragraph of the negative assurance report would contain wording similar to that contained in the scope paragraph of the standard auditor's report in order to indicate that the auditor has done all that in his professional opinion could be done. However, the scope paragraph would end with an exception which sets out the reason why an expression of opinion is not possible; for example, ". . . except that, in common with many businesses of a similar size and organization, internal check on management is limited and there were no practicable audit procedures to determine the effect of this limitation."

The second paragraph of the report would state that because of the limitation referred to in the preceding paragraph, the auditor is not in a position to express an opinion on the financial statements. It would then go on to set out the negative assurance, that is, to the effect that nothing had come to the auditor's attention during the examination which would indicate that the financials do not present fairly.

Although the study has been available since 1967, it was not, as mentioned, accepted in practice or included in the CICA *Handbook*. In fact, the study has been withdrawn. According to a January 1979 research proposal, the CICA has initiated a new audit technique study on internal control in the small business. In 1977 the CICA also published a CPE course, "Audit Problems of Manager Dominance."

English Institute

In 1972, the English Institute published a statement for guidance entitled *Audit Problems of the Smaller Company*. The statement indicates that the duties and responsibilities of a small company auditor are the same as in a large company audit. The small company audit engagement requires the skillful adaptation and application of auditing procedures to the individual small client situation.

Problems arise in the application of auditing procedures to a company employing a small number of administrative staff and controlled and managed by a single proprietor (or a small number of managers). According to the English Institute, these problems mainly derive from:

1. Substantial domination of the accounting and financial management functions by one person, and
2. Limitations in the effectiveness of the system of internal accounting control made inevitable by the small number of employees.

The statement concludes that in the audits of many smaller companies it becomes necessary, despite an extension of audit procedures, to rely to a more significant extent than with larger companies on the representations of management. In such circumstances, the auditor is justified in rendering an unqualified opinion if the evidence available and auditor's knowledge of the company are consistent with and supported by the representations of management. In other words, the auditor's use of representations of management will not of itself require a qualified opinion provided such representations are compared critically against all other available evidence.

The English Institute has expanded its position from *Audit Problems of the Smaller Company* as evidenced by publication (April 1, 1980) of *Auditing Standards and Guidelines*. The new United Kingdom standards present small business reports for a disclaimer (inability to substantiate cash transactions) and a qualified audit report (heavy reliance on management assurance).

Auditing Practices Committee

The relevancy of audits for small companies in the United Kingdom, over recent years, has been a hot topic for debate within the accounting profession. The United Kingdom has over 700,000 registered companies, the vast majority of them private companies, but all with the same audit obligation. That is, many private companies have to be audited solely because they are registered under the Companies Act.

In response to a European Economic Community directive, which would allow legislation to be drafted exempting certain small private companies from a statutory audit, the APC in 1979 published a discussion paper, *Small Companies—the Need for Audit?* The Companies Act at present does not differentiate in any way between the audit requirements of large and small companies, of public and private companies, nor of limited and unlimited companies. One of the primary alternatives being considered in *Small Companies—the Need for Audit?* is a statutory review of financial statements instead of a mandated audit. The review, as presented in the discussion paper, is equivalent in many respects to the review of nonpublic unaudited financial statements in the United States as delineated in Statement on Standards for Accounting and Review Services No. 1, Compilation and Review of Financial Statements.

Other Published Literature

Unique audit problems of small businesses have been addressed in published journal articles and occasionally in auditing textbooks and reference books (e.g., *Montgomery's Auditing,*[9] Anderson's *External Audit*[10]). Appendix A presents a selected bibliography of journal articles.

The thesis of an article by Grollman and Colby is that many of the limitations of a system of internal control for the small business can be offset by owner/manager controls and that the auditor should be able to place greater reliance on the system of accounting controls if these controls are strong and well placed.[11] According to Grollman and Colby, owner/manager controls are most effective when the executive:[12]

Effectively uses accounting information in both budgeting/planning and day-to-day managing of the business.

Seeks explanations for discrepancies between the accounting information with which he is provided and his expectations based on his knowledge of the business.

Is aware of the potential meaning of unusual items, customers' complaints, etc., which come to his attention.

Enlists non-accounting employees (e.g., receptionists, secretaries) to perform certain accounting control functions on a part-time basis where the segregation of duties is important.

Required prior authorization of certain transactions or payments.

The article, however, points out the problem of a concentration of power and notes that the auditor should be concerned about relying too strongly on owner/manager controls in a small business. Consequently, the auditor should recognize the need for applying other audit procedures to compensate for the dominance of the executive.

Stelzer,[13] in agreement with Grollman and Colby, advocates reliance on owner/manager internal controls. According to him, the scope of the examination should be broadened to cover not only the accounting functions but also administrative functions (i.e., budgets, cash projections, standard cost estimates, periodic operating reports and quality control).[14] Both articles also say that auditors of small business need a special internal control questionnaire with questions emphasizing owner/manager controls.

Cottle,[15] in addressing special problems in auditing a small client, explains what additional audit procedures are used to compensate for internal control deficiencies common to small organizations. He does not advocate reliance on owner/manager internal controls. However, he does believe that the basic audit procedures applied in a small business audit are the same regardless of client size. He stresses the need to increase the *extent* of testing in the small business audit. Some of his examples, however, suggest that the *nature* of testing should also be altered (e.g., compare details of deposit slips, remittance advice and accounts receivable postings; confirm accounts payable).

Some of the published journal articles identify differences inherent in the auditor-client relationship when auditing a small company. For example, the relationship between the CPA firm and the client is more intimate, less formal and sometimes characterized by more frequent client contact; the auditor's report is frequently the initial source of hard information on which management bases its decisions and planning; and the auditor frequently is not only examining, but has often prepared from the trial balance, the financial statements on which he is expressing an opinion.

Audit problems of smaller businesses are not extensively discussed in auditing textbooks or reference books. When the subject is discussed, the presentation rarely exceeds two pages. One exception to this is Anderson's *External Audit* which contains an entire chapter devoted to small partnerships and proprietorships. Salient points made in textbook/reference sources are presented below:

Alvin A. Arens and James K. Loebbecke, *Auditing: An Integrated Approach,* Prentice-Hall, 1976, pp. 178-179.

> Due to the frequent lack of sufficient segregation of duties and other important controls, the auditor must recognize that usually less reliance can be placed on controls in a small company. This generally results in more extensive direct tests of dollar balances and less emphasis on tests of the effectiveness of the system. Even though the lack of controls may dictate more testing for small companies than for large ones, certain other considerations often reduce the amount of testing needed. First, the auditor is likely to have a better understanding of the business and the individuals operating the business for a smaller client. Second, the overall level of assurance needed in the audit is usually less for a smaller client because non-involvement with the SEC and other variables significantly reduce the auditor's risk. Smaller population sizes also frequently reduce the testing needed.

Philip L. Defliese, Kenneth P. Johnson, and Roderick K. Macleod, *Montgomery's Auditing,* 9th edition The Ronald Press Company, 1975, pp. 132-133.

> Small companies and some that have not been previously audited often have rudimentary controls. Auditors of those companies must consider whether there is need for functional tests if they already know that controls are weak or nonexistent.
> . . . At a minimum there must be accounts to audit. The underlying system has to be understood and the understanding confirmed. Thus,

a transaction review, at least, is called for in every company being audited. . . .
Functional tests may or may not be needed, depending on the results of the transaction review. Even in a one bookkeeper operation, the accounting system can be well organized, the attitudes toward order, discipline, and accuracy exemplary, and the competence of the bookkeeper outstanding. If so, functional tests may provide evidence that those conditions are present, and the auditor may be able to complete his examination with little extension of tests. Because internal check is lacking, particularly the discipline of segregation of duties, he is likely to decide to perform validation tests at year end instead of at an interim date. But he may not need more extensive validation procedures if the functional tests reveal no significant exceptions or problems. He may decide to rely more than otherwise on comparison and analyses of the interrelationships among accounts to identify misclassifications or unusual conditions—again because inability to segregate duties makes control over that type of error difficult. But, under the favorable conditions cited, extensive verification of transactions or similar vouching is not required.

Unique Implementation Problems

Based on published materials and letters received from practitioners and state societies of CPAs, six implementation problems associated with existing SASs are discussed in this section. Although not pertaining to an existing SAS, a small business audit practice problem relating to engagement letters is also discussed. For some of the unique implementation problems presented, possible solutions are also discussed.

Owner/Manager Internal Controls

One of the most pervasive implementation problems in the small business audit area is the question: Can the independent auditor rely on owner/manager internal accounting controls to establish a basis for restricting audit procedures? In spite of suggestions in current literature suggesting otherwise, it is risky to rely on owner/manager controls to limit substantive testing. Where there are controls by management but not on management, the auditor should design audit procedures with this in mind and absent other factors, little reliance should be placed on internal control. Of course, the auditor may use a small business internal control questionnaire to enhance understanding of the accounting system so that an appropriate substantive-oriented audit program can be designed. The questionnaire also is useful as a client service, e.g., to identify owner/manager controls that can help to reduce the risk of employee errors and irregularities.

Special Audit Procedures

Although SASs typically do not discuss detailed audit procedures, practitioners auditing small businesses need and want guidance on special audit procedures—with "special audit procedures" defined as substantive procedures that are applied to offset internal accounting control weaknesses resulting from limited segregation of duties. Examples of these procedures are: proof of cash, accounts payable confirmations, and observation of property, plant and equipment. Comparisons of substantive audit programs with compliance/substantive audit programs should be helpful in identifying relevant special audit procedures.

Letters to Management

According to SAS No. 20, if the auditor is aware of a material weakness, it should be communicated to management, whether or not corrective action is practicable. Although SAS No. 20 does not require a written report (letter to management), many practitioners have firm policies that mandate written reports.

Practitioners performing small business audits sometimes have difficulty in writing a letter to management (senior management and the board of directors) that is responsive to SAS No. 20. As previously discussed, SAS No. 20 specifically states that internal accounting control weaknesses for which management believes corrective action is not practicable may be presented in summarized form. However, SAS No. 20 does not discuss or illustrate how to present material weaknesses in summary form.

Concerns about the application of SAS No. 20 to small businesses may be alleviated by publishing guidance illustrating letters to management used in small business audits. Appendix B presents one such example.

Engagement Letters

As Benis has noted, engagement letters are not required by GAAS.[16] However, they are widely used today because of the auditor's increased awareness of litigation problems.

Engagement letters are especially helpful in small business audits in explaining to the client that management has primary responsibility for the financial statements. Often the client believes that the auditor has primary responsibility because the auditor prepares the financial statements and drafts the related notes. In an attempt to clarify the auditor/client responsibility, a small business engagement letter might include the following paragraph:[17]

> Although we may prepare or help prepare the financial statements of XYZ Corporation, these financial statements are solely the representations of management. Although we may advise as to which accounting principles should be applied to financial statements and the method of application, the selection and method of application is a determination made solely by management.

The AICPA's *Sample Engagement Letters for an Accounting Practice* (1978) does not present engagement letters that include materials explaining client responsibility for financial statements.

Lawyers' Letters

SAS No. 12 assumes that the audit client has retained an outside attorney to advise on litigation, claims, and assessments. No guidance is provided in SAS No. 12 to cover a situation encountered in a small business audit where an attorney has not been consulted. Logic would suggest that the client representation letter be modified to obtain written assurance that the client has not consulted an attorney and there are no pending litigation or unasserted claims. In some cases, other corroborating information simply may not be available.

Another problem practitioners have pertains to the illustrative audit inquiry letter to legal counsel presented in the appendix to SAS No. 12. The illustrative letter presumes the client will be able to detail each pending or threatened litigation as to: (1) the nature of the litigation, (2) the progress of the case, (3) how management is responding, and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate of the amount or range of potential loss. Similar details are also expected for unasserted claims that are probable of assertion and have at least a reasonable possibility of an unfavorable outcome.

An alternative to the SAS No. 12 appended letter, which is sometimes preferred in small business audits, is a ''short-form'' lawyer's letter that requests the responding attorney to provide the aforementioned details for asserted claims. An example of a short-form lawyer's letter is presented in Appendix C of this paper.

Client Representation Letters

Some practitioners are critical of the illustrative representation letter presented in the appendix to SAS No. 19, Client Representations. The letter covers only the ordinary representations that are generally appropriate for a manufacturing client. The appendix to SAS No. 19 clearly states that the illustrative letter is only one example and thus should be adapted to client circumstances.[18]

When the SAS No. 19 illustrative letter is considered from a small business audit perspective, two immediate problems surface. First, although the letter is not extremely technical, it does include several terms that may not be familiar to a small business client. Second, the letter probably should be tailored to fit the special circumstances of the small business client.

Terms included in the SAS No. 19 letter that perhaps might be defined for the client include the following: irregularities, unasserted claims, and related party transactions. Since these terms have specific meaning in accounting and auditing, it may be beneficial to present definitions within the client representation letter.

Other modifications may be beneficial to the small business client. For example, it may be desirable to have management acknowledge the auditor's recommended adjusting journal entries and indicate whether they have been posted to the accounts. Likewise, if internal accounting control weaknesses are orally reported to management, it may be desirable to ask management to acknowledge this communication. Representations as to the proper segregation of business and personal items and as to capital account transactions may also be needed, especially if the small business entity is a partnership, sole proprietorship, or other unincorporated business.

Audit Reports

A problem peculiar to reporting on a small unincorporated business arises when the owner has other business interests in addition to the entity being audited. In these situations, the audit report should clearly identify the business entity that is being examined. Consideration might be given to recommending that the scope paragraph be modified and a middle explanatory paragraph might be added to clearly identify the business examined. The middle paragraph might appear as follows:

As indicated in Note X to the financial statements, the financial statements referred to above do not include William J. Clip's personal assets, liabilities, revenues, and expenses which are not included in the accounting records of XYZ Proprietorship.

Conclusion

Enough evidence exists to support the assertion that existing SASs are generating implementation problems in the audits of small businesses. The most significant problem pertains to the application of SAS No. 1, Section 320. Practice today appears to condone some reliance on owner/manager internal controls without giving adequate consideration to the risk of management override. Audit attempts to rely on owner/manager controls may result in either overauditing or underauditing, depending on the audit approach used in a given CPA firm.

Additional guidance in auditing small businesses should be developed in the areas of special audit procedures, letters to management, engagement letters, lawyers' letters, client representations, and audit reports. Other areas, not discussed herein, also appear to represent areas where guidance may be needed. Some of these are: related party transactions, statistical sampling and EDP auditing.

The Review of Existing Auditing Standards Task Force is currently working on identifying implementation problems associated with existing SASs. The Task Force has also arranged for a doctoral student to provide additional research input to help identify other unique audit problems, measure the impact of the unique problems on audit efficiency, and suggest solutions to the problems.

Footnotes

1. The Commission on Auditors' Responsibilities, *Report, Conclusions, and Recommendations,* AICPA, 1978, p. 133.

2. AICPA, *Report of Special Committee of the AICPA to Study the Structure of the Auditing Standards Executive Committee,* 1978.

3. *Ibid.,* p. 21.

4. *Ibid.*

5. February 29, 1980.

6. Fox & Company, *ABC Company,* illustrative work papers.

7. AICPA, *Audit and Accounting Manual,* Commerce Clearing House, Inc., 1979.

8. The Auditing Practices Committee of the Consultative Committee of Accountancy Bodies consist of:

—The Institute of Chartered Accountants in England and Wales.
—The Institute of Chartered Accountants of Scotland.
—The Institute of Chartered Accountants in Ireland.
—The Association of Certified Accountants.
—The Institute of Cost and Management Accountants.
—The Chartered Institute of Public Finance and Accountancy.

9. Philip L. Defliese, et al., *Montgomery's Auditing,* 9th ed., The Ronald Press Company, 1975.

10. R. J. Anderson, *The External Audit,* Vol. 2, Pitman Publishing, 1977.

11. William K. Grollman and Robert W. Colby, "Internal Control for Small Businesses," *Journal of Accountancy,* December 1978, p. 65.

12. Ibid.

13. Herbert J. Stelzer, "Evaluating Internal Control in a Small Business," *The Practical Accountant,* September/October 1971, pp. 22-27.

14. Ibid.

15. David W. Cottle, ''How to Handle the Special Problems in Auditing a Small Client,'' *The Practical Accountant,* January/February, 1976, pp. 42-47.

16. Martin Benis, ''The Small Client and Representation Letters,'' *Journal of Accountancy,* September 1978, p. 81.

17. Ibid, p. 82.

18. Brian Zell and Douglas R. Carmichael, ''Management Representation Letters—Adapting Them to the Circumstances,'' *Journal of Accountancy,* March 1979, p. 87.

Appendix A
Selected Bibliography of Journal Articles

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______, ''Practical Evaluation of Internal Control in the Small Audit Engagement,'' *The Michigan CPA,* July/August 1967, pp. 5-18.

______, ''Evaluation of Internal Control in Small Audits,'' *The Journal of Accountancy,* November 1964, pp. 55-61.

______, ''Practical Evaluation of Internal Control in the Small Audit Engagement,'' *The Colorado CPA Report,* July 1964, pp. 6-16.

Appendix B
Illustrative SAS No. 20 Letter for a Small Business

To XYZ Company

As part of our examination of your financial statements for the year ended December 31, 19X1, as described in our engagement letter dated October 1, 19X1, we studied the Company's system of internal accounting control to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards.

Such a study and evaluation does not necessarily cover all aspects of internal accounting control and might not detect all weaknesses in the system. However, it disclosed certain conditions that we believe to be material weaknesses. A material weakness is a condition in which the internal control procedures, or the degree of compliance with them, do not reduce to a relatively low level the risk that material amounts of errors or irregularities may occur and not be detected within a timely period by your employees in the normal course of performing their assigned functions.

[Example of a Material Weakness:]
The bookkeeper is assigned the responsibility of recording all disbursements. However, he/she could intentionally omit the recording of checks. Since he/she also reconciles the bank account a failure to record checks could be concealed through an improper reconciliation.

This weakness could be corrected by having the bank reconciliations prepared by a person who has no other cash duties.

We have discussed the above conditions with Mr. John Jones, who has indicated that due to the limited number of personnel, an adequate segregation of duties is not achievable and that the costs of correcting the weakness would exceed the benefits that would be derived.

This letter should not be distributed outside the Company

[CPA firm, signature and date]

Appendix C
Short Form Lawyer's Letter

To Outside Attorney for XYZ Company

Foot, Tick, & Tie, CPAs, 100 East Broad Street, Lubbock, Texas 43215, are making their usual examination of our financial statements (and the financial statements of our subsidiaries; see attached list). Please furnish to our auditors the information requested below involving matters as to which you have been engaged and to which you have devoted substantive attention on behalf of the Company and/or any of its subsidiaries in the form of legal consultation or representation. Your response should include matters that existed at December 31, 19X1, and for the period from that date to the date of your response.

Pending or Threatened Litigation (excluding Unasserted Claims and Assessments)
Please prepare a description of all material litigation, claims and assessments (excluding unasserted claims and assessments). Materiality for purposes of this letter includes items involving amounts exceeding $25,000 individually or items involving lesser amounts that exceed $50,000 in the aggregate. The description of each case should include:

1 The nature of the litigation.
2 The progress of the case to date.
3. How management is responding or intends to respond to the litigation (e.g., to contest the case vigorously or to seek out-of-court settlement), and
4. An evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.

Unasserted Claims and Assessments
We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosing such possible claim or assessment, as a matter of professional responsibility to us you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

We have assured our auditors that you have not advised us of any unasserted claims or assessments that are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5.

Other Matters
Please identify the nature and reasons for any limitation on your response. Also, please indicate the

amount we (and our subsidiaries) were indebted to you for services and expenses on December 31, 19X1.

The scheduled completion date of the auditors' examination is such that you should send your letter to Foot, Tick, & Tie, CPAs on or about February 6, 19X2.

[XYZ Company Signature and Date]